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UNCLAS SECTION 01 OF 04 TEGUCIGALPA 000010

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TREASURY FOR JOHN JENKINS

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TAGS: EFIN ECON EAID ETRD ELAB PGOV HO
SUBJECT: GOH Starting to Get Serious About Getting An IMF Program

Ref A: Tegucigalpa 3149
Ref B: Tegucigalpa 3479
Ref C: Tegucigalpa 3491

Summary

¶1. (SBU) Honduran government officials are working hard to close the gap with the International Monetary Fund over a new three year Poverty Reduction and Growth Facility (PRGF) program. With plans for new revenue measures of usd 175 million and planned reduction in costs (primarily personnel cuts) of usd 35 million, the government believes it can reduce the central government deficit to three percent of GDP for 2003, down from 5.6 percent in 2002. The GOH is already implementing recommendations by the Fund in the financial sector and working closely with the World Bank-IMF evaluation of the financial sector. A delegation of 4-6 IMF directors will visit Honduras January 17-21. The GOH's macroeconomic team will return to Washington after that visit to review tax reform legislation before sending it to Congress in early February. The GOH hopes that the IMF mission would return to Honduras in March, after approval of the legislation to sign off on a letter of intent, and that the program could go to the IMF Board in April. The IMF's insistence on major reductions in public sector salaries as percent of GDP continues to be the main sticking point, along with the associated timing of the folding-in of teachers into a planned civil service reform program. End Summary.

Significant Revenue Measures Planned

¶2. (SBU) The Ministry of Finance has identified new revenue measures that will raise central government income by 2.8 percent of GDP (about usd 175 million). These measures include: elimination of exemptions from the sales tax, an implementation of withholding taxes designed to reduce evasion of sales and income taxes, broadening of the base for income tax to include a higher percentage of bonuses and benefits packages, and the taxing of the retirement income above a specified level. The government plans to introduce a decree to eliminate the tax exemption for diesel used in the production of electricity (this exemption is believed to be the source of enormous tax evasion); the state-owned power company ENEE would be charged with negotiating an adjustment to the price paid to private electricity generation companies to cover this tax change. The Finance Ministry plans to direct credit card companies to send sales tax payments directly to the tax authorities (the DEI) in order to avoid evasion of sales tax and help collect the planned withholding taxes. Vice Minister William Chong Wong noted that this type of measure has been extremely successful in El Salvador and other countries. The Finance Ministry also wants to require audits for companies with more than ten million lempiras (approx. usd 593,000) in sales annually, and to make financial officers of companies and accounting firms more accountable for intentional tax evasion. Chong Wong is heading up the effort to draft reforms to the income tax law and tax code. The GOH plans to review these draft legal changes with the IMF in mid to late January.

Wage Bill Reductions - Sticking Point with IMF

¶3. (SBU) On the expenditure side, the GOH has identified some one-time measures that will reduce government spending and the wage bill by 0.6 percent of GDP in 2003. Six

thousand teachers who are over 65 years old will be retired in early January (an overdue legal requirement) and will be replaced by younger teachers with lower salaries. Similar measures will be taken among state-employed medical staff. The government is also cleaning up its payroll records (to be completed by February) and expects to be able to achieve savings of 200 million lempiras (approx. usd 11.9 million) per year by reducing ghost workers and individuals receiving multiple full-time salaries.

¶4. (SBU) According to Finance Minister Alvarado, however, the IMF is pushing for additional reductions in the wage bill as a percent of GDP:

2002	10.7 percent
2003	10.1 percent
2004	9.1 percent
2005	8.1 percent

The GOH does not see how they can meet these targets. Alvarado (strictly protect) has now proposed to the Cabinet a public sector wage freeze for 2003. There is some interest but the government remains stymied over the idea of freezing teacher salaries only months after reaching a settlement on teacher wage increases for 2002-2005.

¶5. (SBU) During the December 16-17 consultations between the GOH macroeconomic team and the IMF in Washington, the government finally shared its draft Civil Service Framework bill. Discussion focused on Article 110, which currently says that the teachers will be folded into overall state wage policy by 2006, indicating that the salary provisions of the estatutos (laws governing particular professions) will be eliminated that year. Alvarado said that IMF staff are insisting that the teachers be covered by the civil service reform immediately upon adoption of the law. The GOH has commented that the World Bank is more understanding of their stance on this issue.

The Results: Sizable Projected Reduction in Government Deficit Based on Reforms That Could Get Through Congress

¶6. (SBU) The central government deficit for 2002 is estimated to be 5.6 percent of GDP. This deficit is projected to decline to 5.1 percent in 2003 if no further measures are implemented. The IMF mission in November estimated that the reforms envisioned by the GOH would bring down the central government deficit to 4.0 percent of GDP. Finance Minister Alvarado is now saying that he can get it down to 3.0 percent of GDP.

¶7. (SBU) The government is determined, however, to go to the Congress only once more on major fiscal reforms. For this reason, they want to be absolutely sure the IMF is on board with all legislative proposals before they are sent to the legislature. At the same time, the GOH is certain that any further changes to the agreement with the teachers would undermine congressional approval. On the expenditure side, they believe they've gone as far as they can go. Minister Alvarado noted, in a meeting with Econ Counselor and AID economist on December 31, that the GOH wants to be sure it can deliver what it promises. He alluded to problems that Nicaragua is already having in getting its program approved by the legislature.

¶8. (SBU) The GOH was heartened by the Honduran Congress' easy acceptance of the austerity budget for 2003 on December ¶4. The budget was virtually unchanged from the 2002 budget in nominal terms, with the exception of usd 262 million in needed infrastructure projects, meaning that most ministries will face cuts in real terms of about eight percent after accounting for inflation. The Congress identified new funding for all of these infrastructure projects.

Public Enterprises Still A Concern

¶9. The declining surpluses in the key public enterprises (electricity utility ENEE, phone company Hondutel, and the Port Authority) remain a concern. Finance Minister Alvarado acknowledged that while ENEE's financial picture should improve by 2004-2006 when high cost power contracts are replaced by new low-cost Lufussa and AES projects (see ref b), 2003 is going to be a very tough year for the state-owned electricity utility. The government plans a series of privatization and liberalization initiatives in 2003 and 2004, including privatization of some port facilities, the postal system and some roads. This may help increase government revenues in the short run and efficiency in the long run. Privatization of Hondutel, a twice failed undertaking, remains a politically charged issue, with the government in denial about the true low value of the utility to an outside investor and the fairly strong union trying to

fight any changes. A GOH requested study of liberalization of the telecom sector in Honduras has been approved by the U.S. Trade Development Agency and should begin in the first half of 2003. In the power sector, the GOH has the results of a USAID sponsored white paper on modernization. To depoliticize the issue, the GOH is no longer talking about privatization of ENEE, but rather the unbundling of its generation, transmission and distribution activities.

Financial Sector: Actions Underway

¶10. (SBU) As reported in Ref C, Banking and Insurance Commission President Ana Cristina Mejia de Pereira apparently is making strides in meeting prior action requirements of the Fund in the financial sector. Banco Capital was liquidated on December 19. The GOH needed to tap into about usd 30 million of Hondutel cash to cover the deposit insurance for this failed bank; the Minister of Finance indicated to emboffs on December 31 that this is the last time he will authorize use of those funds to cover a bank failure. The Commission has ordered an appraisal of the value of Banco Sogerin, the other bank which the government took over in May, and hopes to be able to sell it in February (three potential purchasers have shown interest). The Commission is working closely with five additional banks to ensure they meet the higher capitalization requirements. Two or three of these banks will probably be sold to larger banks; in the remaining cases, the shareholders are providing the needed additional capital.

The Road to a Program

¶11. (SBU) The GOH has invited interested IMF executive directors to visit Honduras January 17-21. Alvarado, Minister of the Presidency Luis Cosenza and Central Bank President Maria Elena Mondragon plan to return to Washington right after that visit to provide IMF staff with detailed proposals and projections and to review their drafts for new legislation. The new laws would be submitted to Congress upon their return for adoption in February and to enter into force on March 1. The GOH hopes that the IMF mission would then return to Honduras to complete a letter of intent on a new three-year PRGF, and Honduras' program would go to the IMF board in April. Speed is vital at this point. Quite a few World Bank, Interamerican Development Bank, and bilateral aid programs are on hold until Honduras gets back on track with an IMF program. Honduras is off track for HIPC debt relief and is now accumulating new arrears in its service of its Paris Club debt (arrears estimated at over usd 70 million at this point). USG agencies should track this carefully, as the Brooke Amendment could come into force as early as March 31, forcing agencies such as USAID to begin drawdown plans.

Comment

¶12. (SBU) If the government adopts the identified measures and is successful in reducing the central government deficit to three percent of GDP (i.e. a 2.5 percentage point reduction over the passive expected level), that will be a substantial achievement. Similarly, adoption of the long-awaited civil service reform that would provide the GOH with control over wage policy and create a career civil service would be important moves. If real progress is made in these areas in the next month, the GOH will have a much stronger hand with which to convince the IMF to accept a slower timetable on inclusion of the teachers in the civil service reform.

¶13. (SBU) The other possible development that could help the fiscal imbalance is a resumption of economic growth. It will be important for the GOH to start focusing on measures, other than tax incentives, which can be taken to attract investment and improve the business climate.

Palmer